

# BANKING REPORT GERMANY 2030

HOW TO BECOME ONE OF 150 GERMAN BANKS  
WITH A VIABLE BUSINESS MODEL



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# MANAGEMENT SUMMARY

For some time now, the German banking market has been quite attractive thanks to a large and stable revenue pool of around €115 billion, the political stability and the good state of the overall German economy – both for German banks, but also for banks and innovative service providers from abroad. German banks have been able to limit cost growth, and their risk costs continue to be very low. In comparison with other countries, however, the structurally lower profitability of German banks stands out. Likewise, the deeply embedded three-pillar structure of the banking market with private commercial banks, publicly owned banks and cooperative banks is “typically German”.

- At the same time, the German banking system is on a steady (yet sometimes overlooked) path of consolidation. Between 40 and 60 small banks disappear each year while in the public and cooperative pillars more centralised structures are emerging; in short: the bank pillars are becoming leaner. Overall, it shows the market is equally stable and changing. For three reasons, we do not believe that this stays that way.
- A new “fourth pillar” of foreign banks and new competitors is emerging, which will further fuel competition: the current distinctions between domestic and foreign banks, FinTechs, market infrastructure providers and global technology companies are becoming increasingly blurred. This “fourth pillar” disrupts traditional business models and changes the expectations of customers.
- The modularisation that has already transformed numerous other industries is also increasingly gaining ground in the financial services sector: banks are no longer necessarily the undisputed owner of the customer interface, product supplier and provider of the underlying platforms in one. Rather, the industry is increasingly developing into an ecosystem in which banks may only play one of these roles.

And finally, German banks cannot escape the big drivers of change of our time – such as innovative technologies, changing customer demands, regulations and socio-economic trends. Depending on how quickly these changes will occur, we differentiate between two scenarios for the German banking market: an evolution scenario, in which changes occur more gradually and a disruption scenario, in which changes occur more quickly and more radically. The main challenge for German banks will be to find a sustainable business model for both evolution and disruption.

### **Winners and losers**

Sustainable banking business models will look very different from today's. Banks will have to decide whether they want to act as suppliers or orchestrators. Suppliers provide financial products and services, act as a link between market actors and leverage specialist knowledge or economies of scale. Orchestrators control the interface to the customer and can even bundle complex solutions from different suppliers into a seamless customer experience. The range of sustainable business models available to banks will also depend on whether the banks can leverage a strong local presence or are aiming for a broader multi-regional positioning.

In the evolution scenario, local banks can aspire to leverage their local presence and become a "local incumbent", who covers all financial needs within an economically strong metropolitan region, or slim down to an "ascetic banking model" for regions with lower economic activity. Banks which are active in multiple regions will either need to become "client champions" or focus on a "monoliner model". Those banks that cannot decide or are simply too small will slip into precarious models and lose relevance due to an unclear positioning, e.g. the "victims of consolidation" and "the undecided".

In the disruption scenario, banks need to change even more: they can aspire to become a "guide in the digital jungle" for their clients, a "risk partner", who is able to absorb and process highly structured risks, or an "invisible bank" which is deeply integrated into "plumbing" of other services so that clients do not even recognize the involvement of a bank anymore. There is a considerable risk for banks to turn into "museum banks" that continue to try in vain to cover all products and the entire value chain themselves, or (particularly for smaller local banks) become irrelevant local access points similar to "telephone boxes".

### **The way ahead**

With all the uncertainty about the future, we estimate that there will be significantly fewer banks with a viable business model in the next 10 to 15 years. Depending on the speed of change, we expect the number of banks to shrink from currently around 1,600 to as few as 300 in the evolution and 150 in the disruption scenario.

Besides making choices for a clear strategic positioning, banks will need to utilise two key levers: First, more cultural flexibility, ranging from training staff more continuously to performing better in high stakes client situations. Second, banks will need to create an innovation-friendly environment by fundamentally overhauling their attitude and approach toward change and the ability to innovate. While banks do not tend to be the ideal hotbeds for innovation (think stability and risk aversion), there are several factors that play in their favour, e.g. the innovation mind set of the broader German economy.

Much will depend on the ability of bank executives to move away from their comfort zone of traditional "cost reduction" or "growth strategy" programmes and become more nimble and audacious in how they change their bank.



# STABLE OR CHANGING?



# FINANCIAL PERFORMANCE OF GERMAN BANKS

The past few years have been challenging for German banks. Along with the implementation of extensive regulatory requirements, the consequences of the financial crisis and the implementation of EU state aid procedures, market conditions have changed radically: ultra-low interest rates, the emergence of FinTech and digitisation as well as changing customer behaviour. Nevertheless, several parameters within the German banking market have remained stable – at least at first glance.

German banks benefit from a large customer base of retail and corporate clients, with a €115 billion revenue pool, stable in both composition and size over recent years. Despite high dependency on interest rates, German banks have been able to absorb the period of low interest rates surprisingly well, showing relatively stable net interest incomes of around €90 billion in absolute and relative terms. It should be noted, however, that a continued period of low interest rates is assumed to lead to a deterioration in absolute terms.

## **Revenue pool of German banks**

The revenue pool of banks in Germany has been stable over the years 2013 to 2016 with an average of € 115 billion. 60 percent of this is coming from retail and business clients, while corporate clients contribute just under one-fourth. Asset and wealth management make up the remainder of around one-seventh. More details can be found in the study: “Beyond Restructuring: The New Agenda – European Banking 2017” by Oliver Wyman.

From a cost perspective, despite burdens imposed by regulatory requirements and inevitable investments, German banks were able to mitigate increasing costs to some extent. Their risk costs over the 2006 to 2016 period were comparatively low by international standards. Over the same period, German banks’ operating costs increased by only 1.4 percent per year on average – less than was observed with their peers in Spain, France or the USA. So far, so good.

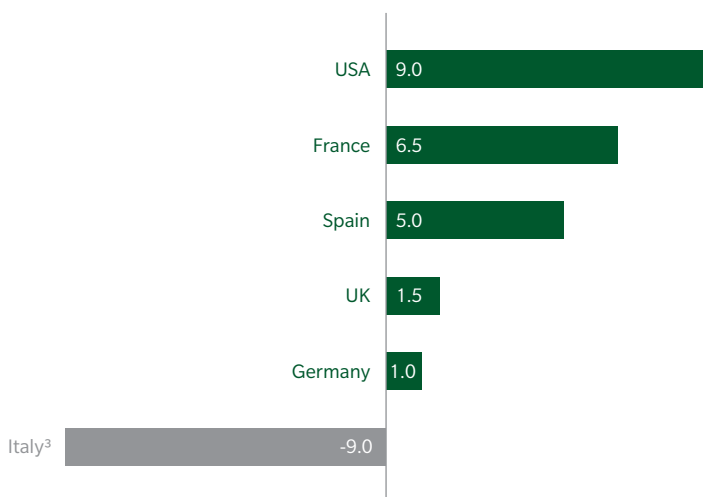
Despite the steadiness of these parameters and the currently very favourable macro-economic conditions, the German banking sector of today is not very profitable by international standards (Figure 1). This may to some extent be owed to the three-pillar structure of the German banking market and related ownership structures of banks: In addition to economic objectives, in particular the public and cooperative banking pillars pursue overarching goals related to local economic development, country-wide offering of banking services and mutual support. This affects return expectations of banks within these two pillars but also the market return expectations as a whole.

Resulting from the implementation of new regulatory requirements<sup>1</sup> and the associated build-up of capital buffers (starting from a low starting point) of approx. €163 billion, the profitability of German banks has actually declined by about one-third over the past ten years.<sup>2</sup> An even further erosion of profits could so far be avoided, specifically by converting hidden reserves. It is uncertain, however, for how much longer these buffers will be available.

The low profitability of German banks is regarded as an indicator of overcapacity by market observers, including regulators – casting doubt on the sustainability of their business models. If the macro-economic environment worsens, risk costs are expected to increase, which would further negatively affect the profitability of German banks.

An additional role is played by the specific German way of consolidation within the banking landscape.

Figure 1: Post-tax return on equity of banks by country, 2016 (in %)



<sup>1</sup> In particular, Basel 3, BCBS 239, IFRS 9 and MiFID II

<sup>2</sup> Capital increase of >50% since 2006

<sup>3</sup> Includes significant one-off write-downs on non-performing loans. In previous years, RoE figures between -3 and 3%



## CONSOLIDATION BELOW THE SURFACE

For some time, the German banking system has been in the process of consolidation – barely noticed by the broader public. Each year, around 40 small banks disappear, particularly in the cooperative and public savings banks sector.<sup>4</sup> They are either taken over by a larger bank within their immediate vicinity or they join forces to form larger institutions.

This is accompanied by a substantial decrease in the number of branches and reduction of the employee base. Consolidation is also happening among the central institutions for the public and cooperative banking networks. As a result, there is now only one cooperative banking central institution; in the public banking pillar, the number of Landesbanken (regional state banks) has been reduced from twelve in 2006 to now only seven institutions.<sup>5</sup> The pillars of the German banking system are becoming leaner.

Additionally, more centralised structures are being created along the entire value chain within the public and cooperative pillars:

- Central product and platform providers for specific customer and market-relevant topics
- Establishing centralised competence centres for the respective overall networks, e.g. for rating models
- Merger of formerly independent IT service providers to a central provider
- Consolidation of certain back office activities in separate entities

<sup>4</sup> Approx. 95% of “bank closures” are within the cooperative and public savings bank sectors

<sup>5</sup> LB Baden-Württemberg, BayernLB, LB Berlin, HSH Nordbank, LB Hessen-Thüringen (Helaba), NordLB, SaarLB

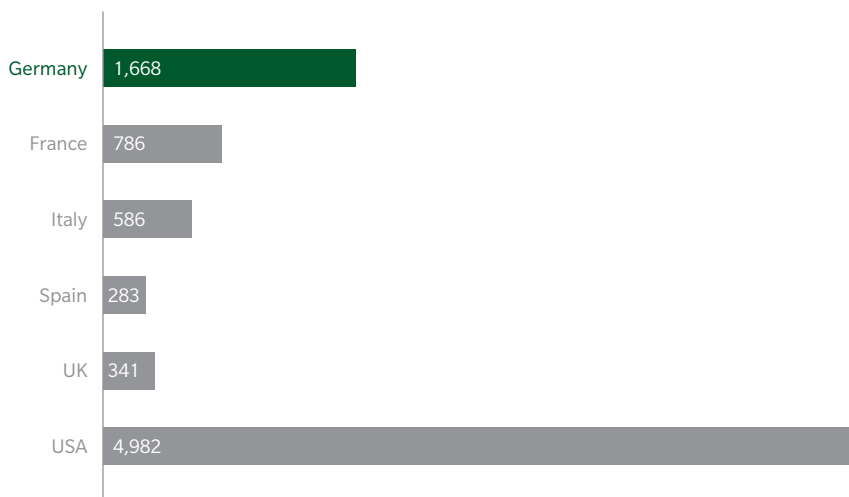
Furthermore, several cross-pillar activities can be observed, especially in areas where considerable infrastructure is required, e.g. in securities settlement or payment transactions.

So far, there is little indication that the typical German market and consolidation pattern will change significantly. Consolidation across the pillars faces major political hurdles, and for private banks, the value creation potential of mergers is limited.

As a result, consolidation of the German banking structure has so far progressed at a slower pace than in other markets. The market remains highly fragmented with over 1,600 banks (2016) and more than 27,000 branches (2015) (Figure 2).

At the same time, a fourth pillar is being created elsewhere in the German banking landscape.

Figure 2: Number of banks, 2017



# THE “FORTH PILLAR” IN THE GERMAN BANKING MARKET

For years, the three pillars of the German banking market have been under strong pressure from foreign banks and new competitors. Increasingly, the distinctions between domestic and foreign banks, and between banks, FinTechs and global technology companies, are blurring. The result is a kind of “fourth pillar” in the German banking market, made up by a heterogeneous bundle of four groups: foreign banks, FinTechs, market infrastructure providers and (mostly) global technology companies.

## Foreign banks:

Large international investment banks have been competing with local German banks for decades in the areas of securities trading and capital markets. In recent years however, foreign banks have also gained a foothold in the German retail and commercial banking business: through the use of their digital operating models; through aggressive growth strategies based on their global, efficient product platforms; and, increasingly, also through their growing local presence. The upcoming Brexit will lead to a further increase in the presence of foreign banks in Germany and thus spur competition for clients and talent – but it will also provide German banks with the opportunity to review their European footprint for efficiency.

## FinTechs:

The initially exaggerated expectations – or fears – about the crowding out of banks by FinTechs have now been put into perspective. What remains is the noticeable performance of FinTechs in select specialty disciplines of banking. Building on this, they increasingly influence the competitive landscape, in particular through cooperation engagements.

### Cooperation examples between banks and FinTechs in Germany

Function	FinTech	Cooperation partners
Photos of paper receipts	Gini	Haspa, HVB, comdirect, DKB, ING-Diba, Consorsbank, Deutsche Bank, Commerzbank, Sparda Bank, Sparkassen
Consolidation of accounts	Figio	Consorsbank, UBS, Deutsche Bank, 1822direkt, Teambank
Community-based investing	Wikifolio	Comdirect, sbroker, onvista
Account opening and switching	Fino	Wirecard, Wüstenrotbank, Santander, SWK Bank, Hanseatic Bank, Commerzbank, Volksbanken, PSD Banken, Audi Financial Services, BBB Bank, Degussa Bank, 1822direkt, Sparkassen
Procure-to-Pay	Tradeshift	Santander, HSBC, Société Générale

**Market infrastructure providers:**

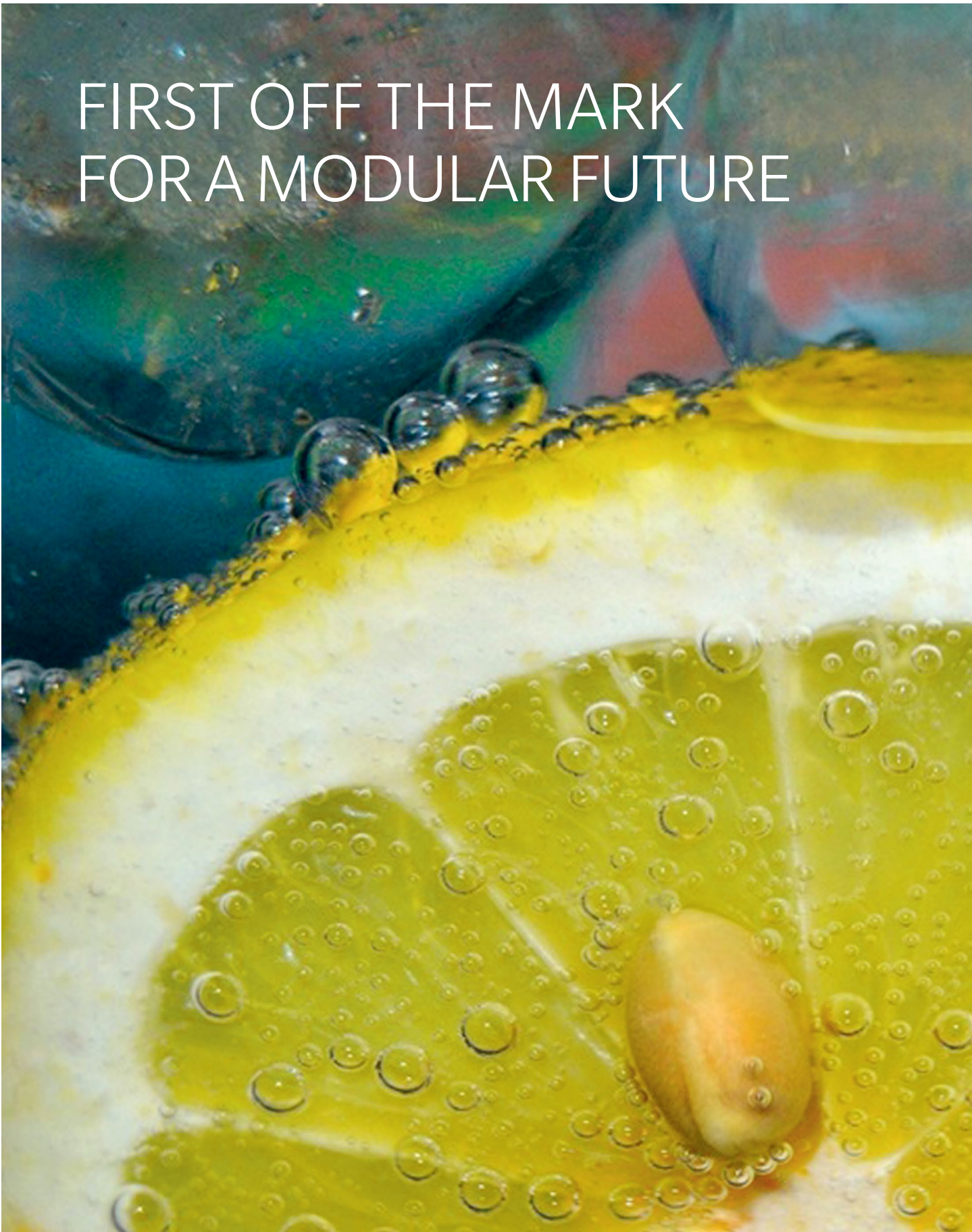
In addition to the established and steadily growing capital markets infrastructure providers such as exchanges, clearing houses, securities service providers and custodians (e.g. Deutsche Börse Group, LCH.Clearnet, BNY Mellon), a number of successful information service providers, data analytics providers and research boutiques (for example Thomson Reuters, Palantir, Autonomous) have positioned themselves in the marketplace and increased their financial services market share at the expense of banks. Particularly the efficient use and commercialisation of large amounts of data and the central positioning within an ecosystem are significant competitive advantages, from which banks can benefit as well. In the current regulatory environment, market infrastructure providers can offer added value and reduce overall industry costs, especially in not directly client-facing areas where banks may shy away from large investments. We increasingly expect cooperation with banks based on the latest technologies.

**International technology companies:**

Global technology companies, which can revolutionise direct access to banking products through their globally established customer platforms (e.g. Alibaba, Amazon, Facebook, Google, PayPal and others), make up the prospectively most important new group of competitors for German banks. This group also includes marketplaces, comparison portals and peer-to-peer platforms that have adopted direct customer interfaces and provide efficient matching and settlement processes. Their technological capabilities and financial resources make players of this group a particular threat to traditional banks. However, this group's actual appetite to invest heavily in compliance with the demanding regulation in the banking sector (e.g. client documentation requirements arising from MiFID II) is debatable.

German banks must expect increasing competition from all four groups. The "fourth pillar" is therefore not primarily a further supporting pillar, but rather an accumulation of challengers of traditional business models – accelerating the change within the German banking system by establishing new business models and customer experiences. Even though some of these new players find themselves in the lucky position to not have to comply with the same regulatory requirements as banks, their offerings change customer expectations even toward traditional banks. Where is the German banking market headed in light of the political, regulatory and economic environment as well as technological innovation and changing customer demand?

FIRST OFF THE MARK  
FOR A MODULAR FUTURE





# DRIVERS OF CHANGE – NOT ONLY FOR BANKS

The big changes of today do not stop short of the German banking market. The underlying drivers can be clearly identified: technology and innovation, customer behaviour and demand, politics and regulations as well as macro-economic and socio-economic developments shape the future for the banks.

For each of these drivers of change (see table), a spectrum of possible developments can be defined: at one end of the spectrum, an evolutionary scenario with moderate, gradual changes compared to the status quo is defined; at the other end, a disruption scenario with rapid developments is posing substantial challenges to banks. In the evolution scenario, new approaches (e.g. robo advice) and infrastructure solutions (e.g. cloud services, artificial intelligence) will

## OVERVIEW SCENARIO PARAMETERS “EVOLUTION” AND “DISRUPTION” ON THE BASIS OF CHANGE DRIVERS, TRENDS AND MACRO ENVIRONMENT

CHANGE DRIVER		EVOLUTION		DISRUPTION
TECHNOLOGY AND INNOVATION	MODULARISATION AND CLOUD COMPUTING	Outsourcing of IT infrastructure, API world >>	Commoditisation of IT, standard APIs >>	Dominance of “Big Tech” firms
	PROCESS TECHNOLOGIES (E.G. ROBOTICS, OCR, NLP) <sup>6</sup>	Automation of existing processes >>	Automation of new digital processes >>	Redundancy of entire process chains
	DISRUPTIVE TECHNOLOGIES (E.G. BLOCKCHAIN, ARTIFICIAL INTELLIGENCE)	New use cases and proof of concept >>	Co-existence of infrastructure alternatives >>	Establishment of new infrastructure standards
CLIENT BEHAVIOUR AND DEMAND	MOBILITY AND MULTICHANNEL ASPIRATION	Mobile phone as anchor for banking products >>	Full digital connectivity “beyond banking” >>	Adoption of AI and bionics in day-to-day life
	TRANSPARENCY AND COST AWARENESS	Sustained price sensitivity >>	Willingness to pay for value added services >>	Full commoditisation
	LOSS OF CUSTOMER TRUST	Ongoing “brand drain” for banks >>	Stable relevance of banks >>	Significant threats to bank relevance

<sup>6</sup> OCR: Optical Character Recognition; NLP: Natural Language Processing

establish themselves as alternative options in certain, clearly defined areas. Digital technologies in the workplace are starting to evolve at a manageable pace and with some preparation time for banks. In the disruption scenario, however, drivers and market structure (e.g. establishment of comparison portals as pivotal customer interfaces) change much faster than in the evolution scenario: In this scenario, taking a “business as usual” approach or adapting to changes at a too slow pace bears enormous risks for incumbents.

Over the next 10 to 15 years, we expect either a disruption or an evolutionary scenario. Despite substantial differences between the two scenarios, both scenarios have in common that growing modularisation will also affect the financial services industry.

CHANGE DRIVER		EVOLUTION		DISRUPTION
POLITICS/ REGULATION	PROTECTIONISM AND BREXIT	Continued geopolitical uncertainty and Brexit outcome >>		Increased protectionism and “cliff edge” Brexit
	CAPITAL REQUIREMENTS (BASEL IV, TRIM <sup>7</sup> ), CYBER RISK	Stable or slightly increased capital requirements >>		Demanding additional requirements due to increase in credit losses or cyber events
	CLIENT AND DATA PROTECTION (MIFID II <sup>8</sup> , GDPR <sup>9</sup> , PSD II <sup>10</sup> )	Provision of customer data to 3 <sup>rd</sup> parties (with client consent) >>		Client data fully monetisable
MACRO-/ SOCIO-ECONOMIC	LOW INTEREST RATE ENVIRONMENT	Accelerated interest rate increase >>	Sustained low interest rates in the mid term >>	Uncontrolled interest rate and inflation
	ECONOMIC OUTLOOK	GDP stagnation >>	Moderate growth >>	Recession and turning credit cycle
	DEMOGRAPHICS (AGE PYRAMID, URBANISATION, MIGRATION)	Overaging and lack of immigration >>	Immigration overcompensates overaging >>	Uncontrolled demographic development
	DIGITAL WORKFORCE	Low digital “activation” of the workforce >>	Agile organisations supported by robotics >>	Purely digital operating models

<sup>7</sup> TRIM: Targeted Review of Internal Models; <sup>8</sup> MiFID: Markets in Financial Instruments Directive; <sup>9</sup> GDPR: General Data Protection Regulation; <sup>10</sup> PSD: Payment Services Directive



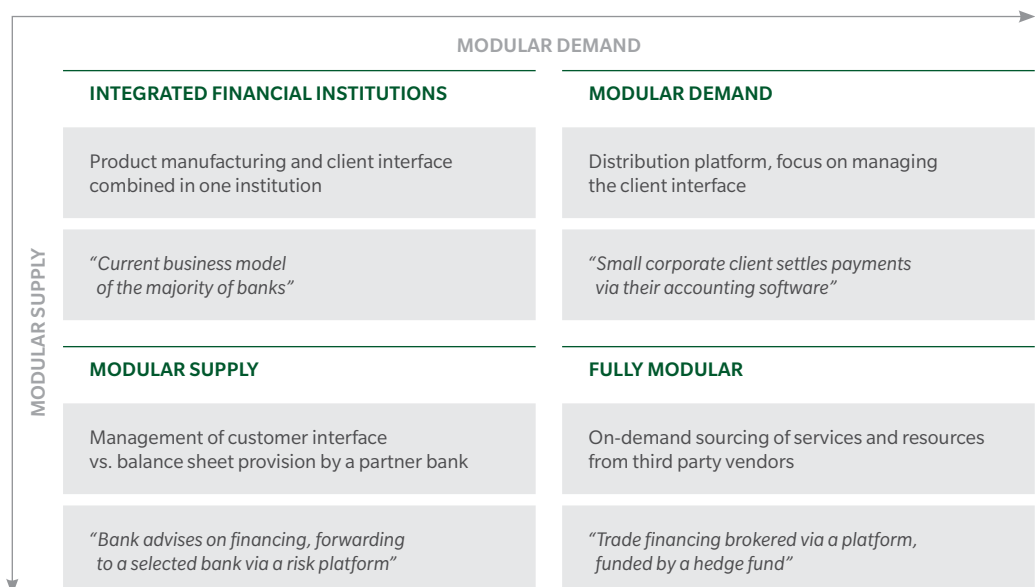
# THE BASIC PATTERN: MODULARISATION OF FINANCIAL SERVICES

The described drivers of change have – to various extents – been affecting all industries for a number of years. This has already led to significant structural changes in several sectors such as automotive and energy. One basic pattern that these developments have in common is the increasing modularisation.

Traditionally, financial services have been provided by integrated institutions covering the entire value chain: distribution, production and infrastructure. Nowadays, digitisation in particular creates opportunities within the financial services industry, facilitating the combination of partial services from different providers along the value chain. At the same time, proper modularisation makes delivery of a seamless customer experience possible – without the clients noticing transitions between providers. We expect that this trend will also prevail in the financial industry, with modularisation happening on both the demand and the supply sides.

The financial services industry will become “modular” along two dimensions: (complete) modular demand means that product providers no longer have an exclusive and direct relationship with their clients. Rather, clients choose products or partial solutions from various providers – using (mobile) applications, aggregators, or comparison portals. (Complete) modular supply exists when product providers no longer cover the entire value chain for one product in-house, but when this product is supplied by several different providers – including with the help of orchestrators (Figure 3).<sup>11</sup>

Figure 3: Modularisation of product delivery and demand  
Modularisation happens along two dimensions (see definition box)



<sup>11</sup> Please refer to: Oliver Wyman, State of the Financial Services Reports 2016 ("Modular Financial Services") and 2017 ("Transforming for Future Value")

### **Modularisation and customer interface**

When it comes to modularisation, the customer interface is of paramount importance. New players are keen to take over these interfaces and become the primary points of contact for clients. In corporate banking, the procure-to-pay cycle is a prominent example: search platforms and marketplaces such as Amazon and Alibaba try to control the entire value chain by supplementing their own offerings with services bought from other providers. In retail banking, the provision of mobile services and integration of devices are seen as a means to this end.

## **STARTING AND TARGET POSITIONS FOR BANKS: WHO WILL BE CALLING THE TUNE?**

Chef or waiter? Supplier or orchestrator? In a modularised world, banks can aim for one of two possible target positions – with far-reaching consequences for their entire business model and sources of profits.

### **Supplier position:**

Suppliers provide financial products and services to other players or are a link between other participants, e.g. by providing a specific infrastructure. Typically, suppliers specialise in certain elements along the value chain and possess specialist knowledge or economies of scale, enabling them to price their (partial) offerings competitively.

### **Orchestrator position:**

Orchestrators play a pivotal role in the value chain: they control the customer interface and combine their own products and services with those of third-party suppliers to meet client needs. An orchestrator enjoys greater degrees of freedom than other players in the value chain.

This in mind, the relative importance of roles as we know them no longer holds true. Suddenly, it is no longer the chef, but the waiter – having direct client contact – who is playing the most important role. With the differentiation in orchestrators and suppliers, banks need to decide which one of these two positions they want to take on in the future – but this, naturally, also depends on their capabilities. Banks' possible courses of action are significantly impacted and limited by their respective starting position.

The structure of the German banking market is characterised, on the one hand, by many independent, local banks, focused on their respective vicinities (archetype "local bank"). On the other hand, there are larger, multi-regional and centrally organized structures, such as large private banks and central institutions of the public and cooperative pillars (archetype "multi-regional bank").

Depending on which scenario the German banking system will have to cope with, different banking landscapes are possible.





# BANKING BATTLEFIELDS OF THE FUTURE

# MAKING CHOICES TO REALISE BENEFITS: SUSTAINABLE MODELS IN THE EVOLUTION SCENARIO

In the evolution scenario, the stability of the German banking market permits market participants to gradually adjust to the upcoming changes. Already noticeable shifts to focus on certain regions or specific products will become more pronounced. Although fundamental business models will remain the same, the evolution scenario will require banks to position themselves as either orchestrators or suppliers (Figure 4).

## **Positioning as “orchestrators” with a regional focus**

Local banks will have the opportunity to become orchestrators by making use of their geographic proximity to their client base and thus becoming an indispensable part of a regional ecosystem (“local incumbents”). Through intensive relations with local players and institutions across all fields of public life – business, culture, education, and so on – they assert themselves as providers of comprehensive financial services solutions. Suppliers and service providers (e.g. for multi-bank aggregation or cloud solutions) are integrated via a flexible technological architecture to offer wide-ranging solutions to clients. This development is facilitated by the continued consolidation in the public and cooperative banking sectors on a regional level, which creates larger entities more capable of responding to change.

The toughest competition for these “local incumbents” is the group of “client champions”, comprising centrally organised banks whose offerings are aligned with customer needs to such an extent that their capabilities and appearance are increasingly converging toward those of local banks. This development will be seen primarily in economically powerful, urbanised regions and metropolitan areas in general.

## **Positioning as a “supplier” with a focussed product offering**

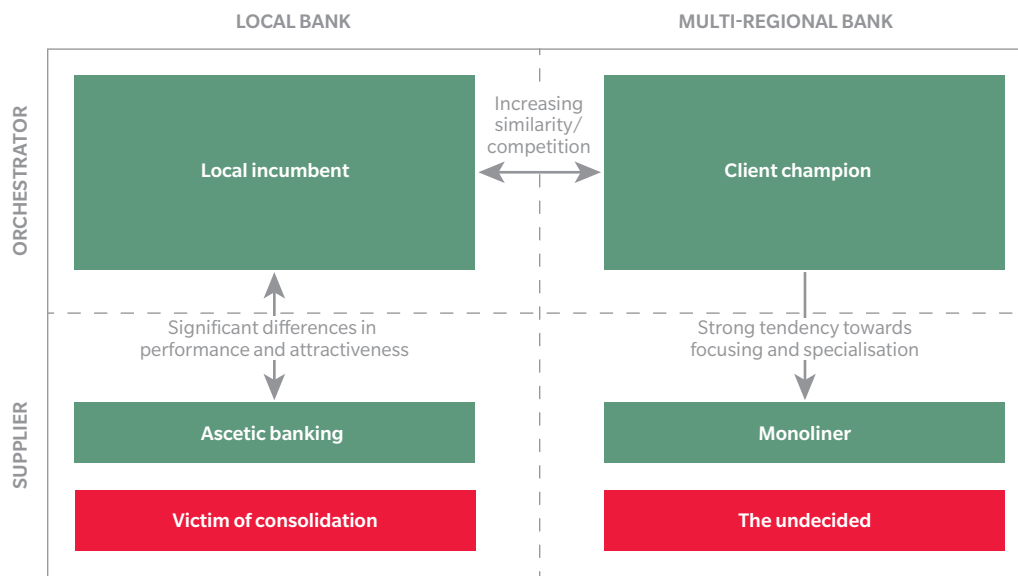
To become a supplier (i.e. providing a basic service or a specific activity in the value chain) in the evolution scenario, both local and multi-regional banks will have to move towards offering a focussed product and service portfolio. As an example for local banks, this could mean providing a set of clearly defined services around bank accounts, given that in non-metropolitan areas – especially true for economically weak regions – often only few other financial services are demanded (“ascetic banking”). Multi-regional banks will either concentrate on certain products – such as e.g. consumer finance (similar to already existing “monoliners”) –, or focus on specific steps in the value chain – as is the case with, e.g., existing infrastructure providers (“quasi-monoliner”).

## **Between and between: The dilemma of the half-hearted**

The illustrated models offer the opportunity for a sustainable positioning. However, even in the slow-paced evolution scenario, the risk of further eroding profitability remains for those local banks that won’t succeed in either making themselves indispensable to local ecosystems or in reducing their portfolio to basic services. These banks will eventually fall victim to the continued consolidation within their sectors (“victims of consolidation”). Similarly, multi-regional banks that won’t develop any significant strengths with regards to clients or products will at some point disappear from the banking landscape owed to increased competition and further eroding profitability (“the undecided”).

However, it is unclear whether German banks will find themselves in the rather comfortable setting of a slow and manageable evolution: There are indications that banks will find themselves in a disruption scenario and will have to adapt to an increasingly fast-moving ecosystem.

Figure 4: Evolution scenario: Sustainable and precarious positions of local and multi-regional banks as orchestrators and suppliers



■ Sustainable models ■ Precarious models

**Local incumbent**

- Local financial services waterfront offering
- Adjusted to needs of local economy
- Intelligent use of multi-regional offerings and “plug-and-play” services, also beyond the public or mutual banking networks (based on flexible technology infrastructure)
- Strong brand
- Connectivity to broader local services “beyond banking” (e.g. E-mobility)
- Strong contribution to local community (e.g. art funding)
- Predominantly in metropole and economically strong regions

**Ascetic banking**

- Provision of local basic financial services needs
- Cost leadership, efficiency and limited product portfolio adjusted to local needs

**Victim of consolidation**

- Sub-critical mass to provide critical capabilities (e.g. connectivity)

**Client champion**

- Strictly client-centric setup (e.g. focus on industry sectors, connected to non-financial services in sector ecosystems)
- Critical capabilities: Delivery of innovation and magnet for talent
- Appetite for investment and risk as key differentiating factors
- Use of platforms (based on flexible technology infrastructure) for both customer acquisition but also sourcing of products

**Monoliner**

- Specialist in a specific product or activity along the value chain
- Competitive on international playing field and/or irreplaceable

**The undecided**

- Inconsistent or late positioning
- Lose relevance due to unclear value proposition

# BANKS OF THE FUTURE: SUSTAINABLE MODELS IN THE DISRUPTION SCENARIO

Given the disruption scenario's rapid developments, banks will inevitably have to adopt new approaches (e.g. cashless payment solutions, as is happening in northern European banking markets) and infrastructure solutions (e.g. cloud services, RPA, artificial intelligence) – at the risk of making entire process chains within their organisations obsolete. In this scenario, the relationship between traditional banks and their clients quickly deteriorates, the market is highly transparent, and the breakthrough of digital technologies in the workplace happens fast and on a large scale (more than 50 percent rationalisation), with drastic implications for employment and compensation structures in the banking industry. In particular, the distinction between local and multi-regional banks will lose its importance. Six banking models are possible in the disruption scenario (Figure 5).

## **Positioning as an “orchestrator”: integrating technologies**

Both local and multi-regional banks can achieve a positioning as orchestrators, functioning as a gateway to the modularised world of financial services: in the disruption scenario, the multitude and complexity of the financial services offered often exceed the understanding and patience of both retail and corporate clients. Players that create, explain and deliver a cutting-edge product portfolio (including third-party components) create sustainable value for their clients (“guides in the digital jungle”).

More far-reaching technological advances enable multi-regional banks in particular to integrate seamlessly with client systems (e.g. payment transaction, or liquidity provision). Clients will increasingly look for solutions that eliminate the need to contact banks directly for their day-to-day businesses (“invisible bank”).

Additionally, those banks that offer to assume non-standard risks for their clients (e.g. where credit portals may no longer be able to offer a standard solution), will remain in demand as “risk partners”. As is the case with “invisible banks”, multi-regional banks also have an advantage to become “risk partners”, given that they can capitalise on their larger size when it comes to diversification effects and the availability of know-how.

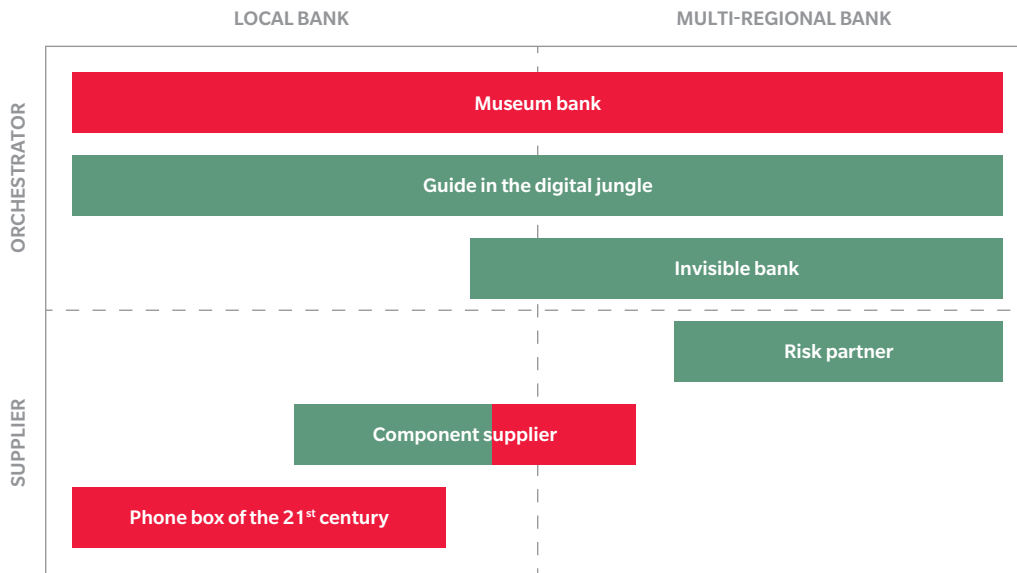
In an ever-changing setting, however, banks – local and multi-regional ones – that cling to the traditional, integrated bank operating model, will face the same issues as formerly successful department stores or hardware component manufacturers not keeping up with the times (“museum banking”).

## **Positioning as a “supplier”: economies of scale help survival**

In the disruption scenario, “component suppliers” in the financial services industry will suffer the same fate as suppliers everywhere – for better or worse: if they succeed in continuously renewing their product portfolio and if they benefit from sufficient economies of scale, they have a good chance to achieve a competitive positioning. If they remain small and less innovative, they will disappear. To achieve an enduring market position, they will likely have to offer competitive services beyond the boundaries of Germany in order to benefit from larger economies of scale (e.g. in the European banking market).

The thinning out of infrastructure – which can already be observed in the areas of brick-and-mortar shopping sites, schools, post offices or telephone boxes, amongst others – will hit local banks disproportionately hard. Their advantage of close proximity to their clients will become less and less relevant (“phone box of the 21<sup>st</sup> century”).

Figure 5: Disruption scenario: Sustainable and precarious positions as orchestrators and suppliers



■ Sustainable models ■ Precarious models

**Museum bank**

- Continuation of outdated and non-profitable structures as integrated “full-range trader” that covers the entire value chain

**Guide in the financial services jungle**

- Banks become the connecting element between people and technology
- Focus on customer care, advice and brokerage activities, supplemented by selected own-manufactured products
- Filter between myriad of offerings and clients

**Invisible bank**

- Provision of access to all financial services offerings
- Full integration in client systems (e.g. SAP)
- Automated settlement via Smart Contracts within pre-defined parameters

**Risk partner**

- Able to absorb and process highly structured transformation risks beyond usual market parameters
- Specialists in structured, specific products, assets and clients

**Component supplier**

- Modular offering of basic financial services products (accounts, payments, automated risk taking, local risk analysis)
- Refinement with third party products or offerings

**Phone box of the 21st century**

- Complete loss of perceived value add by the client
- Sustained cost pressure on decentralised structures

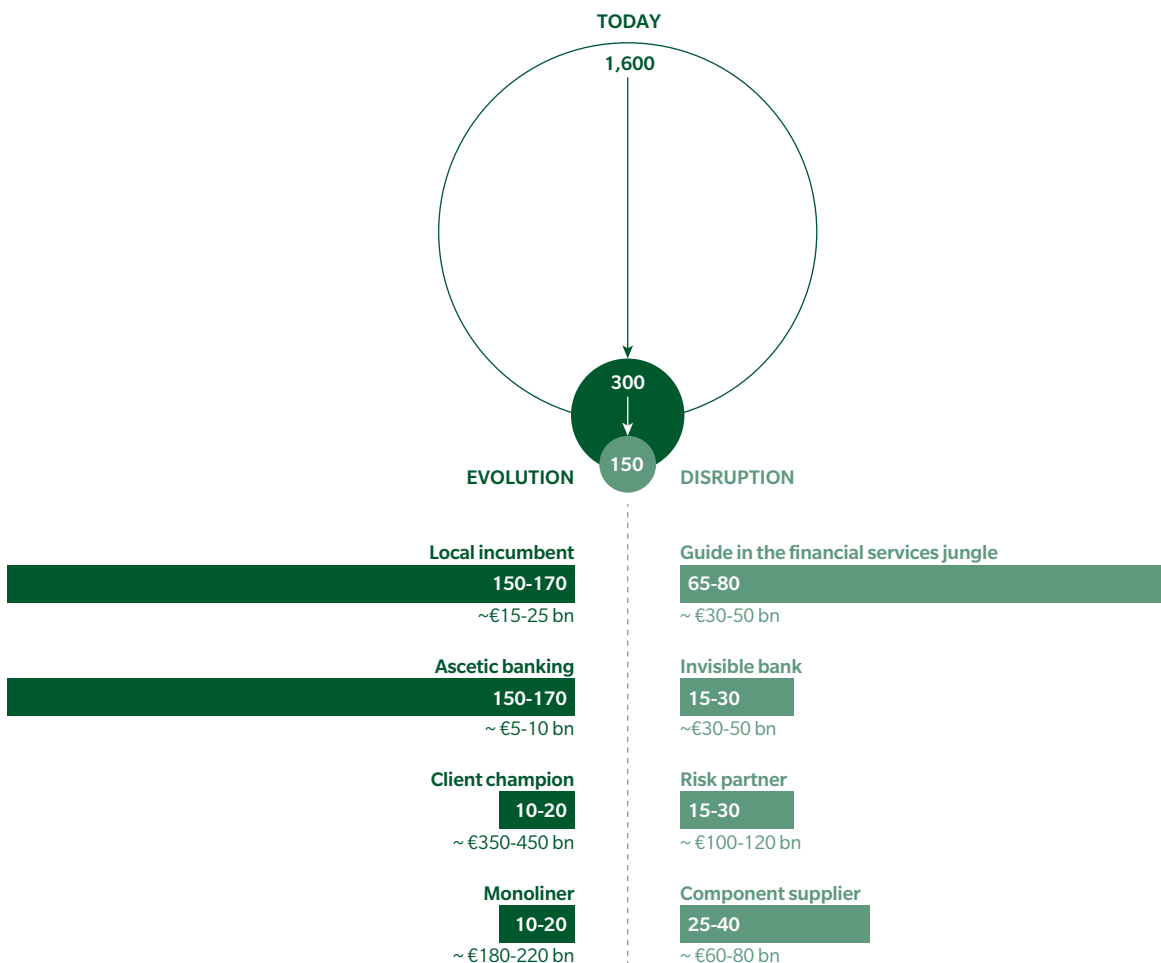


# MARKET STRUCTURE OF THE FUTURE: SIGNIFICANTLY LESS BUT MORE FOCUSSED PROVIDERS

Currently, there are more than 1,600 banks with average total assets of around €5.2 billion each (€4.0 billion in 2006). How will the different market scenarios affect incumbents? For both scenarios, we predict a significant decrease in the number of players engaging in sustainable business models. This sharp decline is a result of inevitable investment needs ahead (Figure 6).

We expect the number of remaining market participants to shrink to no more than 150 to 300 players, depending on the scenario. Changing customer behaviour and new competitors are just part of the reasoning; smaller institutions are also facing the challenge to provide sufficient financial and personnel resources to cope with the necessary strategic business model decisions – a prerequisite to making these investments successful. For private banks, the trend to form larger institutions will mean that cross-border mergers will remain a relevant option. Looking at the public and cooperative sectors, this implies that banks are coming under increased pressure to act as a single, large entity within their respective pillars.

Figure 6: Number of banks and average total assets per bank, in € bn



THERE WILL BE A  
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OF THE FUTURE.

# PREPARING FOR UNCERTAINTY: INNOVATION AND CULTURAL FLEXIBILITY

How should German banks prepare for the upcoming changes? How should they position themselves in an environment that is just being created and that is characterised by high uncertainty?

More than ever, banks are forced to recognise emerging trends faster and to understand and anticipate the resulting implications for their organisations – only then can they react and make the right decisions as to their future direction and positioning. However, to achieve this, banks need to open themselves up for new ways of doing business, especially with regards to cooperating with other players in the market, old and new. These changes will be profound and banks' business models will shift away significantly from the traditional, monolithic model. Which capabilities will be needed to survive? From our point of view, banks will have to (further) develop two main competencies:

- They have to make their organisations more culturally flexible
- They have to improve their innovation capabilities in order to provide novel solutions and achieve a new positioning under different scenarios





# CULTURAL FLEXIBILITY – THE “SECRET SAUCE” FOR TRANSFORMATION AND INNOVATION

The massive changes ahead described in the scenarios will impose high demands on both banks’ senior management and their employee base as a whole. Labour supply will become more constrained (e.g. due to demographics and new digital capabilities) and the structure of work will be subject to changes (e.g. due to automation and artificial intelligence). Much of this is already widely discussed – yet it largely remains ignored in practice.

Notwithstanding, profound transformations have to be conceptualised and implemented, altering both the understanding of particular roles as well as the organisation as a whole (i.e. transformation management, not mere change management). Only few organisations have begun the process of identifying, initiating and implementing the necessary changes in a structured manner. We see much room for improvement in banks’ organisational culture, especially within the following areas:

## **The bank-to-client relationship: empathy when “high impact decisions” are made**

Personal relationships remain crucial for any bank-to-client relationship. When making critical decisions, retail clients (e.g. mortgage loans) and corporate clients (e.g. complex financing instruments) alike will need professional, personalised advice. If “basic services” performed by robots will quickly become convenient to use and error-free, the personal bank-to-client relationship will gain even more relevance as a major differentiating factor.

To deliver comprehensive advice in those high impact situations, two capabilities are indispensable: a high degree of empathy and a holistic understanding and knowledge of the products available to find the best possible solution to a client’s problem (supported by technology). In practice, today, it is rare to find both these capabilities in one and the same person. However, as this job profile is becoming increasingly important, banks will have to find ways to train large parts of their workforce to acquire these skills. They will have to see how and where the few “all-rounders” within the organisation can add the most value and to work out how technology-aided processes can be made available to all employees.

## **Talent management through continuous training**

Bank employees face two main challenges implied by the transformation: First, compared to the status quo, a deeper and more thorough understanding of the digital and technological advancements and their fields of application will become crucial in order to consider the most relevant solutions when advising clients. Second, the ways of working will change and move toward higher degrees of collaboration, e.g. in interdisciplinary, agile teams.

Some banks are already carrying out extensive training programmes, but, more often than not, these schemes take on a rather “passive schooling” approach, keeping answers to crucial topics (e.g. regarding changing qualification profile requirements or future employment needs) to a minimum. But given that the substantial transformation ahead cannot be implemented at once or at short notice – agile ways of working need to be rolled out continuously from one organisational entity to another –, it is important to address these key topics right now.

## **Creating an innovation-friendly environment**

Often, the internal processes within banks do not go well with innovation-friendly cultures. Given the fast pace at which changes happen in the digital age, only four software release cycles per year are no longer appropriate. It will be vital for banks’ senior management to arrange for the transformation to take place in a controllable manner and to embed an increased outward-facing orientation within the entire organisation (i.e. customer benefit as a key metric).

In many areas, banks are not inherently “made for” innovation – also owed to complex legacy IT systems that lack interfaces to connect third-party systems. However, product and service innovations as well as cooperative relationships with other market participants – including outside the rather homogeneous banking world – are a necessity in the scenarios depicting a new, modularised universe of financial services.

# INNOVATION IN BANKING! BUT HOW?

## **Why banks need to innovate**

Due to organisational constraints arising from size, available skills and resources in general, many banks will find themselves at a disadvantage when it comes to adopting and implementing new innovations and technologies in a timely manner. Hence, it is likely that in the future, banks will not be able to offer competitive products and services in all of the areas they used to. However, which parts of their portfolios will be affected the most remains uncertain – just as the direction in which the market is headed.

Banks are therefore facing a dilemma: Should they bet on one specific direction? Bad investments and high sunk costs could be the consequence. Then again, banks will have to address a multitude of innovation-related topics to come up with sustainable models for the future.

In an ambivalent environment, innovative capabilities and an innovation-friendly organisational culture are paramount – but these are exactly some of the fields banks struggle the most with:

- Many banks have a pronounced inward focus. Topics that go beyond crucial issues such as regulation and cost optimisation are often neglected.
- Innovation is inherently risky; banks tend to be risk-averse and are thus not used to assuming high risks.
- Innovation decisions are often made by an unconventional vanguard – but decision making processes in banks are usually either “democratic” or “autocratic”.
- Pioneering projects require substantial transformations. Banks’ organisations, however, are set up for incremental changes; especially cross-silo cooperation presents highly specialised experts and senior management with vast challenges.
- Innovation is often promoted most in areas where good publicity and direct client impact can be achieved. Process automation and platform integration innovations are therefore frequently put in second place – despite their enormous potentials for cost savings and impacting a bank’s long-term-positioning.
- Compared with other industries and owed to their lower profitability, banks have historically only appropriated few funds to innovation and transformation-related programmes. Investments per employee in the banking sector were only 50 percent of those seen in the machinery industry and a mere 25 percent of those in the chemical industry.

The ability to develop or integrate (e.g. via flexible APIs as part of a broader technology management), implement and leverage innovation across the organisation will become essential for banks’ survival.

But are banks really in such a bad starting position?

**Starting points for innovation exist – but many banks are not aware of this**

German banks are actually well-positioned to take on the challenge of innovation in many respects, but they often overlook their own potential:

- Banks with extensive branch networks have access to various client groups. Translating this geographic proximity into valued “client proximity” is not a trivial task, and approaches need to vary by client segment.
  - It surely helps if risk managers in the corporate segment can physically visit the warehouse of a local SMU client.
  - It is less clear whether a local branch really helps to identify a “millennial” customer’s needs when it comes to giving investment advice.
- Thanks to its innovative strength and standing in the world market, the German industrial sector should be a perfect counterpart for innovative bank services – making it an ideal partner for developing and testing new solutions.
- The German banking landscape, home to a great number of independent medium-sized financial services providers and a few larger, centrally organised banking institutions, can serve as an incubator for new ideas. Large institutions can help push and scale innovations that smaller players cannot drive forward due to a lack of critical mass – e.g. by putting into effect cross-sector cooperation agreements as opposed to fragmented decentral cooperation.
- Given growing modularisation, banks will not be required to develop each and every technological solution themselves; instead, they can focus on the flexible integration and application of new technologies as part of their technology portfolio management. In this context, investment prioritisation based on client-facing or internal activities needs to be made transparent.

Indeed, there are leverage points to prepare for a modularised financial services universe.

# OUTLOOK

At the beginning of this report, we pointed out to the stable revenue pool of German banks. Let us dampen the excitement about these otherwise good news a bit: Continued stable revenues also mean that growth opportunities of banks in Germany are limited; additionally, higher risk costs can potentially deplete the aforementioned buffers quickly.

To survive in either scenario, banks will need to (further) develop two main competencies: their cultural flexibility and their ability to innovate. If they accomplish this objective, they can take advantage of solid starting points (customer access, risk and cost awareness, healthy economy) to establish sustainable and successful business models.

Different from conventional “cost cutting initiatives” or “growth strategies”, for which extensive experience exists, these novel topics lie not within the traditional scope of banking organisations’ fields of competence. This will make the persuasiveness and authenticity of senior management a decisive factor to ensure success of the transformation.

As such, the particular skill sets and strengths of their senior management will become an even more important differentiating factor for banks than before. Ultimately, this will determine which banks will survive in the long run.



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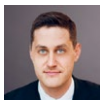
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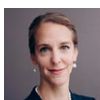
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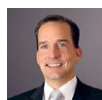
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